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ECONOMIC RESTRUCTURING IN EASTERN EUROPE: AMERICAN INTERESTS

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LETTER OF TRANSMITTAL

SEPTEMBER 29, 1989.

To All Members, Committee on Small Business:

I am pleased to transmit herewith a staff study entitled "Economic Restructuring in Eastern Europe: American Interests," prepared at my request by Dr. John M. Starrels, professional staff member to the committee. I would also like to thank Dr. John P. Hardt, senior specialist on Soviet economics, and Ms. Sheila Heslin, senior research associate, both of the Congressional Research Service, for the substantive editorial assistance they provided in the preparation of this study.

Eastern Europe is passing through a major period of economic transition. The United States, and its Western allies, are destined to play a significant role in assisting this region in devising more competitive, market-oriented approaches to economic policy-making. I have requested this report in order to provide the Congress with a reliable guideline for assessing future United States policy choices toward Eastern Europe.

This study is the first of several which will look at the implications of major changes transforming traditional U.S. relations with the international economy.

JOHN J. LAFALCE, *Chairman.*

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ECONOMIC RESTRUCTURING IN EASTERN EUROPE: AMERICAN INTERESTS

A Staff Study Prepared for the House Committee on Small Business

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INTRODUCTION

The front pages of daily newspapers and the lead stories of network evening news broadcasts have recently informed Americans of historic and dramatic changes taking place in Eastern Europe, particularly Hungary and Poland. Indeed, one major network is closing its Paris bureau and opening up an office in Budapest.

Most of the emphasis has been on political changes being pushed forward, and many observers have suggested that the 50th anniversary of World War II might also mark the end of the Cold War. But the movement toward democratization and the lessening of super-power tensions has also been accompanied by a series of dramatic shifts in "economic rhetoric" which underscores widespread dissatisfaction with the results of command-style economics, and their potential replacement by more flexible, market-oriented systems.

The focus of this study is to evaluate the realistic prospects for a major restructuring of Eastern European economies, American interests in such a restructuring, and how U.S. policy might affect this process.

This study is the first of several which will look at the implications of major changes transforming traditional U.S. relations with the international economy. If the United States is to become a trade surplus nation once again, it will take the concerted effort of all segments of our private sector—including small- to medium-sized businesses—working closely with supportive public policies to compete in the world marketplace.

In this regard, the economic—as well as the political—dimension of change in Eastern Europe carries significant implications for American business. In countries as diverse as Bulgaria and Poland, regimes are belatedly recognizing the value of cooperatives and small enterprises in supplying badly needed goods and services to increasingly restive populations. This realization carries with it potentially significant gains for American businesses of all sizes, and a clear test for American public policy in helping to provide Eastern Europe with the goods and services it so desperately needs.

Not since the late 1940's, when Eastern Europe was forcibly incorporated into the Soviet sphere of influence, has this diverse region been confronted with greater challenges than it is today. On the political front, long postponed demands for individual and col-

lective expression have resulted in an erosion of authority for the ruling Communist parties. The West—particularly the Federal Republic of Germany [FRG]—has traditionally been a borrower for measuring Eastern European tensions. As conditions have deteriorated in neighboring East Germany and Poland over the past several years, hundreds of thousands of emigrants from both countries have descended on West Germany. In a recent twist of emigration flows, East Germans are now trying to exit to the West through Hungary.

Within Eastern Europe, long-suppressed tensions between nominal allies have finally reached the breaking point. Serious political and ideological differences separate orthodox Romania and East Germany from reformist Poland and Hungary. Alarmed over the apparent ease with which Warsaw and Budapest are abandoning political authoritarianism and centralized planning, the remaining bastions of orthodoxy are mounting increasingly vehement attacks against Hungary, Poland, and implicitly the Soviet Union itself.

Economic changes are also transforming the face of Eastern Europe. Throughout the region, ruling groups confront multiple crises, from stagnant productivity and eroding living standards, to more deep-seated, structural weaknesses which reflect a present inability of these countries to provide effective responses to environmental degradation and an overall worsening in the quality of life.

Pessimism is rife throughout the region. Only a decade ago, it was not uncommon to hear Soviet and Eastern European officials proudly boast about socialism's "achievements" in providing full employment and a stable, albeit modest standard of living. While acknowledging the West's material wealth and advanced technological position, Soviet bloc spokesmen inevitably concluded that long-term trends favored socialism over capitalism.

Such confidence is noted by its absence in the Soviet Union and Eastern Europe today. In its place, one encounters fears about the region's desperate effort to prevent a further weakening in its competitive position vis-a-vis the West and a growing number of advanced developing countries in Southeast Asia. Caught in a downward cycle of declining living standards and technological obsolescence, the majority of Eastern European countries are calling for massive infusions of capital, goods, and expertise from the industrial West. Cognizant of the Soviet Union's still massive economic influence, the region's leaders nevertheless recognize that Bonn, Washington, and Tokyo—not Moscow—must play a greater role in the regeneration of their deteriorating economies. In sum, Eastern Europe's enforced isolation from the global economy is coming to an end.

Far from opposing these changes, the Soviet Union is actively promoting them. This attitudinal shift is most pronounced on the foreign policy front. It should be recalled that until recently, the Soviet Union was prepared to employ massive force to keep errant members in line, beginning in 1953 (East Germany) and continuing through 1956 (Hungary), 1968 (Czechoslovakia), and 1981 (Poland). Even today, it would be folly to assume that the Soviet Union would not intervene under certain conditions: to prevent the immediate unraveling of the Warsaw Pact, for example, or the disintegration of social order in a neighboring Communist regime, for an-

other. But Moscow's tolerance for Eastern European diversity, particularly in the economic arena, has significantly increased.

The new Soviet position on relations with Eastern Europe was formally announced in February 1986, when Mikhail S. Gorbachev proclaimed "unconditional respect" for the right of every country "to choose the paths and forms of its development." This line was confirmed most recently in a Gorbachev speech before the Council of Europe in Strasbourg on July 6, 1989:

> The fact that the states of Europe belong to different social systems is a reality. The recognition of this historical fact and respect for the sovereign right of each people to choose their social system at their own discretion are the most important prerequisite for a normal European process.
>
> The social and political order in some particular countries did change in the past, and it can change in the future as well, but this is exclusively a matter for the people themselves and of their choice.
>
> Any interference in internal affairs, any attempts to limit the sovereignty of states—both friends and allies or anybody else—are inadmissible.

These changes have received great attention in the United States, and President Bush's recent trip to Hungary and Poland underlines that growing interest. But the United States is being called upon to do more than simply observe the situation. As a result, major questions confront U.S. policymakers, as well as its allies, in coming to grips with the new realities transforming the region. For example, should more sustained attention and involvement now be given to what were once called the "captive nations"? Or, alternatively, should the United States and its allies hold back for awhile—until the ultimate direction of change in Eastern Europe, and the Soviet Union's role in it, can be more precisely identified?

This study is undertaken in the belief that the shifts now taking place throughout Eastern Europe require an active response on the part of Western countries, particularly in the economic arena where American, European, and Japanese influence can, and should, be used to effect positive reform. Not only does such a posture accord with the objective requirements of most Eastern European countries, it also appears to be in line with long-term U.S. foreign policy interests.

This study addresses five specific issues:

1. The United States Stake in Eastern Europe;
2. Reform and Gorbachev;
3. Reform in Three Eastern European Countries;
4. The West's Impact; and
5. An American Agenda for Eastern Europe.

THE U.S. STAKE IN EASTERN EUROPE

America's interest in post-World War II Eastern Europe is characterized by two contrasting tendencies. As a practical matter, direct U.S. involvement in the region is modest. Including Yugoslavia, total United States trade with the region—exports plus imports—came to $3.8 billion in 1988. As a percentage of outstanding Western private bank claims, U.S. institutions carry a fraction of the load: in 1987, the American portion came to about $1 billion out of a total $51.3 billion This compares to nearly $12 billion for

West Germany over the same period. And direct U.S. investment in the region remains negligible.

United States-Eastern European economic ties are stronger than one might initially suppose, however. Within the World Bank and the International Monetary Fund, U.S. influence is frequently decisive in establishing both the amount and terms under which official assistance is provided to individual Eastern European countries. Similar considerations apply to strategic trade and West-East technology transfer, export credits, and joint venture programs. Nor should the region's direct importance to the United States be overlooked. Although the volume of America's trade with Eastern Europe remains small, a number of U.S. agricultural, capital goods, and service firms have established lucrative market shares in various Eastern European countries, from Caterpillar tractor to Pepsi Cola and American Express.

Foreign policy considerations have traditionally exerted a strong influence over U.S. commercial relations with Eastern Europe. Soviet pressure prevented Eastern Europe from joining the Marshall Plan in the late 1940's, and brought U.S. trade with the region to a virtual halt. When Soviet-American diplomatic and political relations improved in the late 1960's, U.S. trade with Eastern Europe predictably increased. For the next decade or so, the United States played a key role in opening up Eastern Europe to trade and foreign investment, and U.S. support was vital in paving the way for Hungary's and Poland's entrance into the International Monetary Fund during this period. These undertakings would not have been possible without the support of Congress, and during the 1970's, Capitol Hill granted Most Favored Nation treatment to Romania, Hungary, and Poland. By the late 1970's, however, relations between the United States and the Soviet Union once again deteriorated, triggering another downturn in United States-Eastern European trade. One can accordingly assume that the present period of relaxed superpower tensions will, once again, provide a favorable environment for expanded United States-Eastern European commercial ties.

REFORM AND GORBACHEV

Whether that potential is realized depends, in some measure, on how the Soviet Union chooses to meet the challenge posed by economic ferment in Eastern Europe. Present indications suggest that on this issue, the U.S.S.R. has made a sharp, decisive break with the past.

For Eastern European advocates of economic reform, the strikingly more tolerant position of Moscow must be rich with irony. Until Mikhail S. Gorbachev's rise to power, the winds of economic liberalization generally blew from Eastern Europe to the Soviet Union—not that the picture prior to Gorbachev was entirely black and white. During the Stalin era, Soviet policy was unyielding on reform: there would be none of it. After his death in 1953, however, the picture became more complex. From the Khruschev through the Brezhnev period, Soviet policies toward reform were characterized by two tendencies: a growing acceptance of deviations from the traditional centralized planning model in Eastern Europe; unbend-

ing opposition to reformist ideas and practices within the Soviet Union itself.

The practical result was that in Eastern Europe, Moscow tolerated a predominantly private agriculture sector in Poland; market-oriented reform in Hungary; and East Germany's ambitious pursuit of commercial relations with neighboring West Germany.

Such tolerance was noted by its absence in the Soviet Union during this period. In both a doctrinal and practical sense, the Soviet leadership would allow but one brand of "socialism," the Centralized Planned Economy [CPE] which guided the U.S.S.R.'s industrialization drive in the 1930's, and subsequently imposed on Eastern Europe after 1945: "centralized planning, state ownership of the means of production, fixed prices, and the primacy of import substitution industrialization." Occasional forays into uncharted waters, as briefly occurred in the middle 1960's, do not provide an exception to the rule.

Gorbachev, it is fair to say, has drastically revised the traditional Soviet position on reform. Where his predecessors praised the achievements of the CPE, Gorbachev speaks with growing impatience about the excesses, indeed the growing irrelevance of the CPE model. As he wrote several years ago in his book, "Perestroika":

> It is above all the lack of inner stimuli for self-development. Indeed, through the system of plan indices, the enterprise receives assignments and resources. Practically all expenses are covered, sales of products are essentially guaranteed and, most importantly the employees' incomes do not depend on end results of the collective's work: the fulfillment of contract commitments, production quality and profits. Such a mechanism is likely to produce medium or even poor quality work, whether we like it or not. How can the economy advance if it creates preferential conditions for backward enterprises and penalizes the foremost ones.

In several discernible ways, Gorbachev's "restructuring" (perestroika) campaign has already had a major impact on Eastern Europe. First, Gorbachev's break with the past has—intentionally or otherwise—accelerated the demise of the Council For Mutual Economic Assistance [CMEA]. Established in 1949 by Stalin, the CMEA's major function has been to integrate Eastern Europe into the Soviet economy. National differences between Moscow's European satellites prevented the CMEA from making good on its supranational mission. By the late 1970's, it had largely fallen into disuse. Gorbachev made a belated effort to revive the CMEA in 1985. At the 41st session of the organization in December 1985, the Council announced "a Comprehensive Program" to narrow the East-West technology gap by promoting joint ventures in research, design, and production among member states. But Eastern Europe's technology dependence on the West has, if anything, increased since then. In calling for an end to the Soviet bloc's isolation from the global economy, Gorbachev has raised new questions about the CMEA's future.

Second, Gorbachev's reform campaign is accelerating the integration of Eastern Europe into the global economy. The domestic portion of Gorbachev's perestroika program has generated a good deal of criticism from the remaining bastions of orthodoxy in East Berlin and Bucharest. But the new Soviet desire to join the General Agreement on Tariffs and Trade [GATT], the International Mon-

etary Fund, and eventually the World Bank is fully in line with the foreign economic aspirations of even the most conservative Eastern European regime. With the possible exception of Romania, the CMEA countries recognize that their future prospects lie in closer cooperation with the advanced industrial and newly industrilizing countries. A return to the autarchic world of the late 1940's and 1950's is considered to be out of the question.

Third, and most importantly, Gorbachev's support for wide-ranging economic restructuring in his own country and in Eastern Europe has probably strengthened the hand of indigenous reform groups throughout the region, particularly in Hungary and Poland. The reappointment of Rezso Nyers to the Hungarian Politburo in mid-1988 is particularly noteworthy. As the reputed father of his country's New Economic Mechanism [NEM], Nyers played a leading role in Hungary's initial reform effort. But in 1974, Nyers lost influence during the high point of conservative reaction against the NEM. It is hard to imagine that Nyers' comeback has nothing to do with Gorbachev's strong support for the present Hungarian reform drive.

REFORM IN THREE EASTERN EUROPEAN COUNTRIES

Three pivotal countries have been chosen for examination in this study: Hungary, Poland and Yugoslavia. The first two choices make obvious sense in the present context of rapid change sweeping Eastern Europe. But why include Yugoslavia? For two reasons. First, although Yugoslavia remains outside the Warsaw Pact and the Council for Mutual Economic Assistance, its economic and political structure, and the problems deriving from it, remains Marxist. Second, subsequent reform efforts undertaken in that country have more in common with Eastern than Western Europe.

HUNGARY

Throughout Eastern Europe, political change has been the decisive influence on economic life in post-World War II Hungary. From the late 1940's through the early 1960's, Hungarian policies were dominated by Stalinist efforts to impose a uniform system of centralized planning and control throughout Eastern Europe (until 1948, this included Yugoslavia). In practice, this meant a rapid program of industrialization, the collectivization of agriculture and the nationalization of banks and private businesses. These pressures—ideological in origin—generated severe strains throughout Eastern Europe; and nowhere more so than in Hungary, with its strong tradition of entrepreneurship and wide-ranging commercial ties with the West.

The 1956 revolution set the stage for improved economic conditions in Hungary. Although the uprising was crushed by Soviet tanks, the new, Soviet appointed, leader Janos Kadar, eventually reached a modus vivendi with his country's occupiers: Hungarian acceptance of Soviet hegemony in foreign affairs, in exchange for which it received a green light from Moscow to initiate wide-ranging economic restructuring at home.

The first steps toward this goal were taken in the early 1960's, culminating in the promulgation of the New Economic Mechanism

[NEM] in 1968. The NEM, to be sure, was not an experiment in free market capitalism. Centralization and planning—the two hallmarks of Marxist economics—remained. But in significant ways, the NEM did result in important modifications of the traditional system. For the first time in post-World War II Hungary, economic power was devolved from the center to individual enterprises and production directives were largely eliminated. These changes in turn made it possible for enterprise executives to devise more flexible production and marketing strategies.

The path toward reform since then has been anything but smooth. In 1972, the NEM came under severe attack from party conservatives, alarmed over the growing influence of market forces and the increased wealth of farmers. External events also played a role, notably the oil price explosion of 1973, which significantly contributed to Hungary's future balance-of-payments difficulties. In reaction to these pressures, the regime reimposed direct controls over individual enterprises and rescinded earlier decisions to allow unprofitable firms to go bankrupt. The authorities also increased price subsidies.

The reform impulse remained alive, however. In the late 1970's and early 1980's, Kadar once again took the offensive in supporting a new round of measures: running the gamut from reductions in subsidies for food stuffs to provisions granting larger numbers of companies the right to issue bonds and the possibility of engaging in direct transactions with Western businesses. In an effort to make Hungary's banking system more competitive, the regime established a two-tier system in 1987, headed up by five commercial banks and a Central Bank. Notwithstanding these, and other efforts, however, Kadar proved unable to arrest Hungary's economic slide. In May 1988, he was replaced by Karoly Grosz, to whose programs and prospects we now turn.

In comparison with the situations a decade ago, a much stronger political consensus on behalf of far-reaching economic reform exists in Hungary today. Why? A large part of the answer is to be found in the unending stream of bad economic news. Both real income and private consumption have been on a steady decline over the past year; a condition exacerbated, if not caused, by the government's severe austerity program and the increasingly serious strains imposed on Hungary by its $18 billion external debt. Even if Hungary were inclined to repudiate its reform program because of the costs it presently exacts on the population, the momentum pushing Hungary toward further restructuring and openness appears to be irresistible.

What now? Imposed austerity measures at home and the absence of massive Western assistance mean that economic conditions in Hungary will remain grim over the foreseeable future. Given the problems of the past 40 years, with at least two generations of entrepreneurism lost, it is difficult to overestimate the difficulties involved in attempting any widespread restructuring. The 1987 austerity program, for example, ostensibly represents a serious intent to implement long overdue bankruptcy laws. On closer examination, however, it appears that the present reform effort might well go the way of earlier ones, with a further resulting loss in the com-

petitiveness of Hungarian firms. As one expert, Zoltan Barany, describes it:

> According to the new program, enterprises that are consistently producing losses will be liquidated. During 1986, the state paid out approximately 25 percent of the total state budget to subsidize inefficient economic units. In September [1987], a law was passed that specifically provided for the winding down of nonviable enterprises, not fewer than 400 of which would qualify for liquidation. In one case bankruptcy proceedings were begun in the spring [of 1987], but the persistence of the authorities in the implementation of the new law is doubtful because of its political implications. . . . Even with the introduction of public utility work and retraining programs for unemployed workers, the social and political effects of such large-scale unemployment are difficult to foresee.

External pressures may, however, prove decisive in pushing Hungary toward serious, and sustained reform. Disenchantment with the Council for Mutual Economic Assistance [CMEA] is accelerating Hungary's integration into the Western trading system. About 40 percent of its gross national product [GNP] derives from trade, roughly divided between the CMEA and the rest of the world. Hungary's goal is to shift a larger percentage of its trade away from the CMEA and toward the West. There are obvious advantages in doing so. Hungary's hard currency debt can only be serviced through expanded exports to the West. But those possibilities will be limited as long as Hungary is required to send close to 50 percent of its deliveries to CMEA countries. Cutting back on those deliveries would have encountered serious opposition from Moscow in the past. No longer. Soviet leaders appear ready to accept such a change. It will take a good deal of time, however, to fully implement the idea. One potential interim solution—put forward by none other than a member of Hungary's then ruling quartet, Karoly Grosz—is to place bilateral trade with the Soviet Union on a "hard currency accounting basis."

A shift of this magnitude, of course, is no less fraught with dangers. Budapest's Institute for Economic and Market Research estimates that roughly one-third of Hungarian firms affected by such a reversal in trade patterns would ultimately survive. But this risk must be balanced against the costs of further delaying Hungary's entry into the global economy.

Poland

Cataloging Poland's ills is easy. With the obvious exception of Romania, no country in Eastern Europe suffers from so many intractable problems as does Poland, prominently including hyperinflation, low productivity, disappointing levels of technological innovation, a declining housing stock, to uncompetitive products, and a staggering external debt burden. A listing of its problems, however, does not do justice to the present situation. Consider the standard of living in Eastern Europe's most populous country. The average monthly wage of 6,000 zlotys covers food costs and little else. It is estimated that fully 60 percent of the nation's wage earners are failing to make ends meet. Housing constitutes an especially serious concern. Approximately 21 percent of the urban population, and 62 percent of their rural counterparts, lack basic plumbing facilities. Some 2 million people are on the waiting list for coopera-

tive apartments. In a country which once boasted a vibrant agricultural sector, Poland has become a net importer of food products.

Poland's internal difficulties are mirrored on the external front. It presently owes Western governments and commercial banks $39 billion. With interest payments estimated to reach $2.8 billion in 1989, Warsaw is not expected to fully meet its obligations. This, despite the fact that Poland has generated a current account surplus over the past few years. The perverse, if inevitable, result is that potential insolvency further complicates Poland's efforts to obtain badly needed support within the Western financial community.

Determining the cause of Poland's malaise is a more difficult undertaking. Certain obvious points deserve mention. For all intents and purposes, the nation was destroyed during World War II. Twenty percent of the population, some 6 million people, perished between 1939 and 1945.

After World War II, Poland was saddled with a new set of burdens imposed on the country by the Soviet Union. These burdens continue to plague Poland. The roots of the present crisis go back to the late 1940's when the Stalinist system was forcibly imposed on the country. Very little, if any, consideration was given by Soviet authorities to the difficulties associated with any such effort that did not take into consideration very substantial differences in culture, history, factor endowment, and size separating the Soviet Union from Poland.

Stalin's decision to isolate his newly acquired Eastern European empire from the rest of the world had a particularly severe impact on Poland. Where countries such as neighboring West Germany were encouraged to take maximum advantage of the emerging international division of labor through product specialization, Poland was required to imitate the Soviet industrial structure. Sectors which might have yielded Poland comparative advantage—electronics, synthetic fibers, and plastics—were neglected. This autarchic approach effectively prevented Poland from joining the global economy; a good deal of its subsequent debt and balance of payments problems can be traced to these initial developments.

The history of reform in Poland has, not surprisingly, been an unhappy one: running the gamut from the decollectivization of agriculture and continuing through the heavy borrowing years of the 1970's, up to the austere present. But as in Hungary, there remains a strong consensus in support of reform measures which, over time, will hopefully bring about a visible improvement in the standard of living. For Poland the key questions must be: "what kind" of reform, and what are the means at hand for bringing it off?

It will not be an easy passage. Unlike Hungary, which continues to enjoy relatively high living standards and a modicum of political consensus, Poland has neither. The competition for political control in that country, if anything, makes the job of building massive support for such a program problematic, at best. Existing policies for addressing the nation's crisis appear to move in opposite directions. For example, the pre-Solidarity government had given verbal support for the creation of small-scale, entrepreneurial cooperatives. Well and good. One of Poland's most pressing challenges is to develop the kind of commercial and entrepreneurial culture which plays such a vital role in Hungary. In practice, however, represent-

atives of large-scale industries have been able to sabotage such efforts. It remains to be seen whether a Solidarity-run government can do better.

Like Hungary, but even more so, Polish leaders in the past have been extremely reluctant to attack underlying structural problems which are progressively undermining the country's ability to compete internationally. In principle, of course, its various governments have paid lip service to the logic of industrial restructuring: old, outmoded plants need to be replaced by newer, more competitive ones. In practice, however, economic concentration is encouraged; and the influence of well-entrenched industrial interests have up to now been able to prevent a major shift toward more flexible, market-oriented enterprises.

The formation of Poland's first non-Communist government in the post World War II era could, however, provide reform forces with a new opportunity to finally undertake far-reaching change. We are not talking about miracles. Poland's structural crisis is the result of unfortunate historical developments and failed policies; it will accordingly require years, perhaps decades to overcome. A vastly altered political climate, however, could go a long way toward supplying the one vital ingredient so far lacking in previous reform efforts: a broad-based consensus on the legitimacy of the government and its recovery program. In an interview a day before he took over his official duties, Tadeusz Mazowiecki, Poland's first non-Communist Premier in 40 years, struck the appropriate theme:

> Everything has already been said and written on how hard things are for us—but Polish society is not really fully aware as to how difficult coming out of a crisis really is. So the first thing is to make people realize that, and then also make them realize that the government I create cannot be blamed for what has already happened, but can be judged for what we do from now on.

YUGOSLAVIA

Since its expulsion from the Soviet bloc by Stalin in 1948, Yugoslavia has become the leading exponent of market socialism. While various changes have been introduced in how it functions over the past three decades, the fundamentals of Yugoslavia's unique system of worker self management, decentralized decision making and flexible planning remain in place.

Yugoslavia's economic system is a hybrid of free enterprise and socialist control. On the one hand, firms are expected to generate profits; enterprises are expected to compete for sales in global markets; restrictions on joint ventures and foreign investment have been liberalized; planning is of the indicative, nonbinding variety; and the power of regions to determine both short- and long-term economic prospects is pronounced. On the other hand, successive Yugoslav regimes are strongly committed to the values of egalitarian socialism. In practice, this means that the central government has the prerogative, if not the authority, to intervene on a variety of fronts: from restrictions on the sale and acquisition of property to policies designed to increase income equality. And its system of worker self-management is—on paper at least—far and away the most advanced of any socialist country. To square the circle, Yugoslavia is simultaneously an associate member of the CMEA and the

Paris-based Organization for Economic Cooperation and Development [OECD], and enjoys special ties with the European Economic Community [EEC].

One of the most powerful forces in Yugoslavia's economy, "regionalism," has little, if anything to do with "capitalism" or "socialism." A direct expression of the Nation's Federal system, economic policy making in Yugoslavia flows through various provinces and six separate republics of varying size and wealth: from wealthy and politically influential Slovenia to the vastly poorer republics of Montenegro and Macedonia—to the most ethnically heterogeneous republics of Croatia and Serbia. In addition, there is the area of Kosovo, now a subsection of Serbia and presently a center of explosive confrontation involving ethnic Albanians versus the Serbian and Montenegrin groups. It should hardly come as a surprise, then, that the present debate about economic reform in Yugoslavia is as much, if not more, a reflection of these regional cleavages between various republics than about the individual merits of the policies themselves.

Through the late 1970's, Yugoslavia's economic performance was fairly impressive. As a middle income Mediterranean country engaged in a rapid process of industrialization and structural change, Yugoslavia's growth record compared favorably with its Greek, Spanish, Portuguese, Turkish, and Israeli neighbors over this period. Employment growth throughout the decade was healthy and its balance of payments position was reasonably sound until the end of the decade—largely a result of earnings on services, that is, transportation, tourism, and remittances from Yugoslavs working in Western Europe.

The present decade, however, has been another matter entirely. As in Poland and Hungary, austerity programs introduced in 1982 have visibly reduced living standards; unemployment stands at 15 percent; inflation has grown from 60 percent at the beginning of the 1980's to an estimated level of 900 percent for 1989, while the country's outstanding external debt nearly tripled between 1980 and 1987, moving from $5.7 billion to $15.6. These debt levels, in turn, are imposing severe strains on the Federal budget and accelerating regional conflicts over how scarce financial resources are to be spent. Political unrest, in the form of strikes and work stoppages, is accordingly on the rise. Large delegations from factories in Croatia, Serbia, and Vojvodina converged on the central government in Belgrade in the fall of 1988 to register their dissatisfaction. The unrest continues.

Yugoslavia no longer commands the serious attention from the West that it received a decade ago. In an era of national self assertion in Eastern Europe, the West—particularly the United States—no longer views Yugoslavia as a symbol of defiance and independence from Moscow. The probability of a Soviet attack on Yugoslavia has visibly decreased since Gorbachev took power; so Western security concerns in the Balkans are less pronounced than they were a decade ago. Correspondingly greater interest is now being shown by Western countries in Hungary and Poland. More than ever before, Yugoslavia is very much on its own.

But the "cause," if not the reality, of reform lives on. The 1980's have witnessed a spate of Yugoslavian liberalization programs. One

of the more publicized efforts involved the so-called Kraigher Commission, which between April 1982 and July 1983 issued 17 reports. The basic thrust of these studies, and subsequent ones, is that Yugoslavia must initiate actions designed to facilitate the transition to a unified market mechanism. How? A look at the most recent government effort may provide an answer.

The present reform program was introduced in March 1989 by the new Yugoslav Prime Minister, Ante Markovic. Its primary goals are to abolish administrative price controls, reestablish a functioning foreign exchange market and promote import liberalization. To accelerate structural change, Markovic has proposed major deregulatory initiatives, notably in the banking industry. The goal is to shift the locus of control on bank boards from enterprise directors to independent shareholders. Since most banks in Yugoslavia were set up with funds from enterprises, it will be interesting to see how this proposed change in control will fare. With inflation running at an annual rate of 900 percent, pressure is growing on the government to introduce an anti-inflationary program. Markovic's answer has been to tighten monetary and credit policies in the hope that such measures will eventually squeeze it out of the economy. In view of deteriorating living standards, the government hopes to avoid recourse to wage freezes.

As in Hungary, and to a greater degree in Poland, however, the path to reform in Yugoslavia is strewn with major obstacles, running the gamut from serious balance-of-payments problems and inflationary pressures, to seething regional conflicts. This last issue requires additional comment.

This is not the place for a disquisition on Yugoslavia's regional dilemmas. Suffice it to say that a key obstacle to reform is the well-documented fear of undeveloped regions that the rewards derived from such efforts will inevitably flow toward the richer areas of the country. That fear appears to be one major reason why the drive toward "market socialism" slowed down in the 1970's.

Thus, the inevitable question: can reform be carried out without some strengthening of Federal powers at the expense of regional and republican prerogatives? "The various people huddled together under the name of Yugoslavia—Serbs, Croats, Slovenes, Macedonians, two sorts of Muslims—find it so hard to get along with each other that, in economic terms, Yugoslavia barely exists" comments a recent report carried in the London Economist (August 12, 1989). Unless there is a reduction in those geographic barriers, economic reform in Yugoslavia will have to wait. Such an eventuality could be catastrophic.

THE IMPACT OF THE WEST

Eastern Europe's economic renewal is taking place within a larger environment of change in the world trade and finance system. Of special relevance for Eastern Europe is its relationship with the capitalist West—which over the past decade has become an increasingly significant force in the reform programs of Eastern European countries. Several dimensions of that relationship bear special relevance.

Dependency

Whatever revitalization strategies are ultimately chosen by Eastern European leaders, Western countries promise to play a crucial role in determining their success or failure—and not for the first time. Confident about the prospects of East-West détente, Western governments did their part by extending generous lines of credit to countries such as Poland, Hungary, and Yugoslavia during the 1970's: and in the process helped facilitate a more than fivefold jump in Eastern Europe's imports of high technology and manufactured goods from the West between 1970 and 1980, moving from $5.3 to $27.3 billion; Western commercial bank loans to the region increased by approximately $45 billion between 1975 and 1980.

Eastern Europe's dependence on the West can be expected to continue despite the substantial volume of capital and technology it imported from the West a decade ago. Why? A large part of the reason has to do with faulty investment strategies: too many steel, shipyard and chemical sectors; not enough food processing and computer firms. The result: Eastern Europe will be forced to replace a good part of its capital stock to improve its competitive position abroad and living conditions at home. The region's leaders are hopeful that the West—again—will provide the necessary capital to facilitate the next phase of adjustment.

Western Views

But is the West prepared to respond in kind? The short answer appears to be yes. The European Community [EC] has recently come forward with a $660 million assistance program for Hungary and Poland, half of which is to be contributed by EC Members, the remainder to be provided by non-EC Western countries. Already in the pipeline is $298 million worth of food assistance donated by the EC to Poland. The Community is also in the process of enacting its first trade agreement with Warsaw; such an arrangement should make it easier for Poland to export items to Western Europe. If enacted, EC quotas on Polish exports of shoes, steel, silverware, and other items would be loosened. And since 1980, Yugoslavia has enjoyed special access to the EC's market.

President Bush's recent diplomatic success in Hungary and Poland has awakened hopes in both countries that significant infusions of United States assistance will soon be forthcoming. Those expectations have been fueled by a new White House assistance strategy which strongly relies on the International Monetary Fund [IMF] to coordinate a larger Western aid effort toward Poland. Notwithstanding these initiatives, however, the United States continues to lag behind Western Europe in Eastern European recovery efforts. The present United States assistance package for Poland and Hungary comes to a modest $194 million—as well as a promise to help Poland reschedule its loans. There is also support within both the administration and Congress for a long-term, 3-year Most Favored Nation status for Hungary. But in the overall scheme of things, these are exceedingly modest commitments. Why is the United States holding back?

For two major reasons. First, budgetary realities effectively preclude large-scale commitments of economic assistance to the region.

Prospects for an Eastern European equivalent of the Marshall Plan—funded largely by the United States—are accordingly poor.

The second reason why United States economic involvement in Eastern Europe lags behind the EC derives from longstanding geographic and commercial realities. Western Europe has traditionally had a greater incentive to cultivate markets to its immediate East than has the United States. The erosion of the Iron Curtain separating the two parts of the continent from each other will, if anything, accelerate the movement toward economic cooperation between Eastern and Western Europe. Such a development could, to be sure, benefit the United States as well. But in the absence of a sustained U.S. commitment to take advantage of the new commercial environment, no substantial economic benefit to American business is likely to occur.

Notwithstanding these different levels of commitment, however, both the European Community and the United States remain skeptical about prospects for Eastern Europe's renewal. Not without reason. The 1970's witnessed a substantial transfer of Western capital and technology to Romania, Hungary, Poland, and Yugoslavia, as well as the Soviet Union. To what effect? Instead of improving, however, domestic and external conditions in Eastern Europe have, if anything, worsened over the past decade. Although the region's current account position has marginally improved over the past few years, its gross debt burden (net debt plus foreign exchange reserves) rose to a new high of $114.3 billion in 1987.

Of the three countries under discussion, only Hungary will probably be able to raise new loans from Western banks in the foreseeable future. With little choice in the matter, Western governments will undoubtedly continue to support debt rescheduling agreements with Poland, Hungary, and Yugoslavia. But hopes for new infusions of capital largely rest with the International Monetary Fund [IMF] and the World Bank. And those prospects are modest indeed. The IMF granted Hungary a $350 million standby credit in May 1988; but a combination of worsening external debt and a larger than anticipated budget deficit prompted the IMF to halt payment of the last installment this past spring, pending new austerity measures. With respect to Poland, the fund is now committed to supply the country with another dose of capital; but such assistance will continue to depend on the IMF's subsequent acceptance of a serious reform package, which has yet to be forthcoming. Yugoslavia no less requires a new injection of Western capital, but in view of its present crisis, prospects of this taking place are considered to be very poor.

Western Alternatives

As a practical matter, however, the West cannot simply wash its hands of Eastern Europe, even if it were inclined to do so. Which it is not. Geostrategic realities alone require an active Western presence in the region, particularly in the wake of recent agreements on conventional force reduction, and the prospect of substantial savings in the Western defense budget that such steps inspire. Three separate, but related strategies for dealing with Eastern Eu-

rope's economic problems are available to the West. In order of priority, they are:

(1) Structural reform.—Declining living standards, a large, and growing, external debt, amidst a rising tide of popular dissatisfaction fueled by Gorbachev's reform program in the Soviet Union—these are the necessary, if unpleasant, conditions within which long-term reform in Eastern Europe is unfolding. Under these circumstances, the West's foremost responsibility is to insist that financial assistance to Eastern Europe be conditioned on a given country's readiness to implement long overdue structural reform: that is, an end to public sector monopoly, liberalized capital markets, combined with a revitalized private sector and meaningful price reform.

Both the IMF and the World Bank should be given lead responsibility in carrying forward these policies. Growing political instability throughout Eastern Europe will make it difficult, if not impossible, for individual leaders to impose austerity programs on their own. Evidence suggests, however, that they might have an easier time justifying new stringencies if they can in effect say, "the Fund and the Bank made me do it." Such leverage seems to already be having an effect. Hungarian officials, for example, have recently undertaken significant budget reductions in direct response to IMF pressures.

The World Bank's exposure in Eastern Europe is also expected to increase, particularly in Poland. The Bank is presently studying the possibility of financing the construction of food processing facilities there; helping Poland grapple with its pollution and transportation problems are also areas where the Bank could be expected to play a vital role. Present estimates are that Poland could soon be receiving between $300 and $550 million in credits on an annual basis from the IMF and World Bank. Expanded participation of these institutions in Eastern European reform efforts should also facilitate the flow of private capital and business expertise to the region.

The quickening pace of change in countries such as Hungary and Poland has generally received a positive response in the West. As well it should. Eastern Europe's new generation of reformers want, and need, major capital transfers from the West over the next few years. Just days before President Bush's visit to Warsaw this past summer, for example, Solidarity leaders unveiled a $10 billion multiyear assistance request, consisting of: $2.7 billion from the IMF; $3 billion from the World Bank; and $4.3 billion in new bilateral credits. The West's initial response to this initiative, however, has been skeptical.

But skepticism toward Eastern Europe's new capital requirements may need to be tempered by a longer term sense of strategic purpose in the West. It ill behooves the United States and its allies to indulge the fantasies of Polish, Hungarian, or Yugoslav reformers. Failure of the West to set visible limits on assistance programs only encourages antireformist forces in those countries. But an overly restrictive posture in responding to such requests contains even greater dangers.

The irony of the present situation is obvious: after 40 years of Cold War, East-West relations are moving in a direction highly

congenial to United States and Western European economic and strategic interests. Notwithstanding the past record of economic mismanagement and squandered loans, the West is presented with a unique opportunity to reshape the map of post-World War II Europe. An integral part of that reshaping process requires Western capital. Meeting all of Poland's or Hungary's assistance demands would be folly, at least over the short run. Under appropriate and clear-cut conditions, however, a willingness to meet them at least half way makes compelling sense. A major priority for the West, then, should be to collectively define both the conditions and opportunities under which it is prepared to lend assistance to Eastern Europe.

(2) Regional and bilateral measures.—But the IMF and World Bank cannot be expected to go it alone. Regional and bilateral initiatives on the part of Western European countries can also go a long way toward ending Eastern Europe's isolation. Some progress has already been made on this front. A major step in this direction was taken in 1988 when the EC signed a joint declaration with the Council for Mutual Economic Assistance recognizing the right of the European Community to negotiate trade agreements with individual CMEA members.

Such a step has special significance for Eastern Europe. Close to 50 percent of total trade (exports plus imports) between the two economic blocs is transacted by the European members of the CMEA. In 1987, this came to $26 billion. Both sides benefit. Eastern Europe's modernization program requires enhanced access to Western European markets: in substantial measure, that access is now provided by the EC. The European Community also derives considerable advantages from this association. Why? Because the eastern European marketplace provides a ready source of demand for many community products which have become uncompetitive in the West. With respect to these export industries then, the EC derives two advantages: Maintaining employment in uncompetitive industries and reducing domestic pressures for subsidies. Overall, the Community currently provides more than 60 percent of CMEA imports of high technology items.

Special bilateral ties between socialist East Germany and capitalist West Germany constitute another form of cooperation between Western and Eastern Europe. On an annual basis, the two Germanies transact between 6 to 7 billion dollars' worth of trade between themselves. Special credit lines extended by West Germany to its Socialist neighbor allow East Germany to use its own, nonconvertible currency to buy West German goods. The European Community allows West Germany to classify trade with the German Democratic Republic as intra-German commerce, thereby making East Germany a defacto member of the EC. West Germany also has especially close economic relations with Poland; its debt and investment exposure in that country is the largest among Western countries. Similar bilateral arrangements exist between Hungary and Austria.

(3) Trade liberalization.—Over the long term, the West should make serious efforts to accelerate East Europe's movement into the global economy. This process is already well advanced for Hungary, Poland, and Yugoslavia, all of whom are presently members of the

IMF, World Bank, and the General Agreements on Tariffs and Trade [GATT].

But this is only a beginning. The next major step for the West is to encourage Eastern European countries to accelerate industrial and technological restructuring by expanding their ties with advanced capitalist and developing countries. This will not be easy. Industrial restructuring exacts severe employment costs in the short term; and it remains an open question whether Eastern Europe's restive populations are truly prepared—after years of broken promises by their governments—to absorb potentially painful jumps in prices and unemployment as necessary adjustment costs which usually accompany medium- to long-term market liberalization programs. For the forseeable future, Eastern Europe will confront a most difficult situation. The West, however, can help ease this transition by increasing the flow of technology, know how, and investment to the region—and by working toward Eastern Europe's full inclusion in the global trade and payments system, and the disciplines such membership requires. If Eastern Europe is truly committed to modernization, it has no other choice.

AN AMERICAN AGENDA FOR EASTERN EUROPE

Massive shifts in the balance of economic and political power in Eastern Europe require a bolder, strategic vision on the part of the United States toward the region. To facilitate matters, the following initiatives should be undertaken by the Bush administration and the Congress.

I. Help Poland Manage Its Debt Crisis

Excepting Poland, Eastern Europe's balance of payments and external debt position today constitutes a major improvement over the early 1980's. This improvement is the direct result of Eastern Europe's draconian adjustment program which it began in the early 1980's. Although the area's debt burden is projected to increase by some $21 billion from 1988's level of $97 billion to $118 billion by 1998, only Poland finds itself unable to meet its debt obligations. Contrast this with the present debt position of Latin America. Though wanting in various respects, Eastern European economic leadership has clearly made greater strides toward managing its debt than many other countries. As a result, the real worry facing reform-minded Eastern European leaders lies not in servicing "existing" debt, but in coming up with desperately needed new sources of capital from official and private lending institutions.

These generalizations do not, however, apply to Poland. The United States must recognize that the newly installed Mazowiecki government's commitment to far-reaching market liberalization requires matching financial commitments by the West. In view of United States budgetary limitations, what, if anything, can Washington do to help Poland manage its debt burden? Two things. First, it should cooperate with other Western governments in helping Poland reschedule and reduce its debt burden. The goal is not to cancel Poland's debt, but to establish politically sustainable repayment requirements; and in so doing, free up valuable converti-

ble, that is, Western currency earnings that can be used to support domestic reform objectives.

United States influence should also be used to encourage greater IMF and World Bank exposure in Poland. A good deal of progress has already been made on this front, with both the Fund and the World Bank on record in support of substantially larger flows of capital to Poland. President Bush's recent call for a larger multilateral assistance program for Warsaw, however, will probably need to be repeated over the coming months.

II. Review United States Trade Laws and Practices Toward Eastern Europe

Commercial, as well as political criteria should guide United States policies toward Eastern Europe. More liberalized regimes in Hungary, Poland, and the Soviet Union, and the prospect of major changes in East Germany and Czechoslovakia, should significantly reduce potential points of conflict between the United States and these countries on human rights, foreign policy and technology transfer issues.

Similar considerations should apply to relations between the United States and its Western allies. The most acrimonious disagreement within the Western alliance over the past decade has been triggered by disagreements over East-West trade. With the threat of Soviet aggression considerably eased, and the prospect of increasingly independent foreign policies on the part of Eastern European countries, the United States should do everything in its power to reduce potential conflicts with Europe and Japan over East-West commercial issues.

Closer to home, the United States should undertake a serious, long overdue review of trade laws specifically applying to Centralized Planned Economies [CPE's], from West-East technology transfer to the use of tariffs and quotas in managing the flow of imports from these areas. Future U.S. trade policy toward Eastern Europe should take into consideration the liberalization efforts now being undertaken there. United States security concerns in dealing with Eastern Europe should not be slighted. In light of America's severe balance of payments deficit, however, Washington should assign greater weight to improving this Nation's competitive position in the global market, prominently including Eastern Europe.

To facilitate a strengthened United States economic presence in Eastern Europe, Washington should support bilateral programs to expand private sector ties between the United States and Eastern Europe. The Bush administration's recent commitment of $125 million to support the establishment of enterprise funds in Hungary and Poland constitutes an important first step in such an undertaking. An agreement between the United States and Poland to facilitate such ties was signed in Warsaw on September 20, 1989. Well and good. But Congress and the administration should, if anything, redouble efforts to encourage a substantially larger United States private sector presence in Eastern Europe. Poland merits immediate attention.

Poland's new Solidarity-led government urgently requires major inflows of private capital and accompanying expertise. Among Western countries, the United States occupies a unique position of

trust in Poland: with the political leadership itself, and the society at large. The United States Government cannot substitute for the private sector in establishing a stronger competitive position in Poland. Through diplomatic and commercial channels—trade and investment missions, for example—however, Washington can, and should, encourage our private sector to expand its presence in Eastern Europe's largest market.

How should this be done? Two steps should be taken. First, United States private capital and expertise could be put to work in helping salvage four key areas of Poland's economy: health care, agriculture, housing, and, more broadly, the environment. American managerial assistance is especially needed in Poland today for the training of doctors for service in private clinics; improving the yield and quality of agricultural produce; helping Polish builders rehabilitate old housing; providing practical advice to city and industrial planners in reducing pollution.

A second important step in strengthening America's private sector presence in Poland requires an instrument capable of encouraging the population to invest its sizable dollar assets—estimated by Solidarity to be about $1 billion—in an American corporation or bank chartered in Poland. This money presently serves no useful purpose; as seed capital, however, it could provide the foundation for a much larger capital pool; which could, in turn, be used to fund American-Polish joint ventures across a range of private sector initiatives.

III. Provide Greater Support Toward Multilateral Development Efforts

In view of the present reform agenda in Eastern Europe, the United States should redouble efforts to help these countries make the transition from state socialism to market socialism, and beyond. This will not be a simple matter. Budget stringencies constitute major limitations on U.S. assistance efforts. But that hardly releases the United States from taking imaginative initiatives to assist Eastern Europe in its economic renewal. The best approach would combine modestly expanded credit and assistance programs with larger multilateral initiatives on the part of Western Europe and Japan. Simultaneously, the United States should act as a facilitator to encourage expanded World Bank and IMF lending to the region.

The U.S. role in multilateral assistance efforts deserves special attention. If America's fiscal requirements prevent the United States from directly contributing large amounts of capital to Eastern European reconstruction, Washington still retains great influence over the actions of the IMF and the World Bank. America's allies expect no less from us. From the vantage point of longer term U.S. foreign economic policy goals, we should seize the opportunity.

IV. Apply Strict Conditionality and Reciprocity

The United States must, however, be very clear in conveying its long-term economic intentions to Eastern Europe: while prepared to expand assistance to the region, Eastern European countries must display a matching willingness to meet legitimate United

States concerns. One of the most pressing requirements is to obtain a binding commitment on the part of countries receiving U.S. assistance to guarantee foreign investors the uncontested right to own private property in the host country. Hungary's recent decision to allow just that should serve as a model for other European CMEA countries.

V. Consider the Soviet Union

The United States should design future economic initiatives toward Eastern Europe with an eye to changes taking place in the Soviet Union. This is because Soviet reform efforts will, inevitably, have a significant impact on Eastern European countries. Continued Soviet sensitivity toward its security concerns in the region also require a sensitive United States posture. Though informal, a deal of sorts appears to have been struck with Moscow on United States initiatives toward Eastern Europe: an expanded American presence in the region is welcome, as long as it is not used to accelerate an already weakened Soviet position. This leaves the United States with considerably greater diplomatic room than it had in the past.

VI. Organize for the challenge

Finally, major changes taking place in Eastern Europe require a correspondingly larger United States economic and security commitment to the region; akin to the Berlin and other special task forces during periods of heightened East-West tension. As matters now stand, the United States lacks an appropriate mechanism for coordinating its economic and security policies toward Eastern Europe. It's time to create one.

CONCLUSION

Economic and political changes taking place in Eastern Europe present the United States with major commercial opportunities: operating bilaterally and within the larger framework of the Western alliance and multilateral institutions. It promises to be a long-term struggle. But with appropriate executive and congressional branch support, the United States can play a major role in Eastern Europe's reemergence as a self-conscious, effective partner in global affairs. This is an obligation worthy of the United States. Properly managed and executed, it is one which we are well positioned to fulfill.

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